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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No. 693
No. 694

315 U.S. 817

GEORGE W. COVINGTON AND KATE ELLIS COVINGTON,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

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COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Your petitioners, George W. Covington and Kate Ellis Covington, pray that writs of certiorari issue to review the judgment of the Circuit Court of Appeals for the Fifth Circuit in case No. 9806 decided June 9, 1941, and rehearing denied July 8, 1941. The Fifth Circuit in part affirmed the United States Board of Tax Appeals and in part reversed the Board.

Opinions Below.

The opinion of the Board of Tax Appeals (R. 18) is reported in 42 B. T. A. 601. The opinion of the Circuit Court of Appeals (R. 50) is reported in 120 Fed. (2d) 768. Rehearing denied July 11, 1941 (R. 65).

Jurisdiction.

The jurisdiction of this Court is invoked under the provisions of Section 1141 of the Internal Revenue Code, and Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

1. Are executory contracts for the purchase and sale of Commodities on the New York Produce Exchange (R. 20), and similar exchanges, Capital Assets within the meaning of Section 117(b) of the Revenue Act of 1936?

2. If said executory contracts are Capital Assets, does the extinguishment of said executory contracts prior to the delivery date (R. 21) through the medium of the Clearing House of said exchange, involve a sale or exchange, as is required by Section 117(d) of the Revenue Act of 1936, in order that the $2,000 limitation on net losses may apply?

3. Are the Commissions paid by one engaged in the business of trading in Commodity Futures (R. 20) deductible in full as ordinary and necessary business expenses, or are they excluded by Article 24-2 of Regulations 94, promulgated under the Revenue Act of 1936?

4. If Article 24-2 of Regulations 94, promulgated under the Revenue Act of 1936, applies to Commodities as well as to Securities, does the said Article 24-2 preclude the deduction of SELLING commissions as well as purchasing commissions?

Statute Involved.

The applicable parts of the Revenue Act of 1936 and the Regulations promulgated thereunder are set forth in the Appendix.

Statement.

These causes arise in the determination of your petitioner's income tax liability for the years 1936 and 1937.

The petitioners are individuals, husband and wife, whose residence is Hazlehurst, Mississippi. George W. Covington, hereinafter referred to as the petitioner, is the president and a director of the Mississippi Cottonseed Products Co., which he organized in 1927 to consolidate and take over twelve or thirteen cottonseed processing plants then owned in large part by the petitioner.

The petitioner has been engaged for some twenty years in trading individually in commodities futures related to cotton products, including cotton, cottonseed oil, cottonseed meal, and lard. Petitioner devoted a substantial part of his time to trading of this nature during the taxable years, having almost daily transactions. He was during the taxable years a member of the New York Produce Exchange, the Memphis Cottonseed Exchange, Merchants Exchange, and the National Cottonseed Products Association. Due to these memberships, petitioner received certain information furnished by the exchanges and was entitled to reduced commission rates. Petitioner kept abreast of the current movements of the commodities through the trade journals to which he subscribed and through statistical information compiled with the assistance of a research man employed for that purpose. (R. 19-20.)

In the taxable years broker's commissions paid by the petitioner and petitioner's losses on trading in futures contracts were as follows:

	1936	1937
Trading losses	$25,120.56	$58,716.00
Commissions	2,880.00	39,619.00

The United States Board of Tax Appeals decided (1) that Commodity Futures Trading losses incurred in the years 1936 and 1937 were capital losses and subject to the $2,000 limitations of Section 117(d), Revenue Act of 1936, and (2) that commissions paid in connection with such trades were deductible but only to the extent that they are attributable to sales.

The Commissioner appealed to the Fifth Circuit (R. 27) because any commissions were allowed, and the taxpayers appealed to the Fifth Circuit (R. 37), complaining of the holding that such trading losses were capital losses and subject to the $2,000 limitation, and because all commissions were not allowed.

The Court of Appeals for the Fifth Circuit consolidated both appeals into case No. 9806 (R. 44).

The Fifth Circuit on June 9, 1941 (R. 50) sustained the Board of Tax Appeals on the points complained of by your petitioners, and reversed the Board on the point complained of by the Commissioner (R. 55). Petition for Rehearing was denied July 11, 1941 (R. 56).

The taxpayer's position is that:

As a Futures trader he does not own or acquire property. All that he does is to enter into executory contracts (R. 20), looking to the future, to buy the property referred to in the contracts. He doesn't, by his dealing, become the owner of any property, he merely enters into executory contracts which are executed, not by transfer of property, but by closing them out at a profit or loss, under the rules of the exchange, without a sale or exchange of property being involved. Future trading on Commodity Exchanges involves neither purchases in its initiation nor sales in its consummation. All that is accomplished by the public outcry on the floor of the exchange is the setting of the price and the determination of the contracting parties. The highest bidders then contract at the price set for the future delivery of the commodity. Contracts closed out before delivery are not sold. A separate sales contract is made with the high-

est bidder and the clearing house of the exchange, to which all contracts are transferred, extinguishes offsetting contracts and makes a money settlement of the price difference. There is then neither the sale nor exchange of the commodity or of the contract. There is only the extinguishment of a contract to buy and a contract to sell, and a money settlement for the price difference; and that

As a Futures trader, such being his business, he is entitled to deduct as an ordinary and necessary expense commissions paid on such trades; that Article 24-2 of Regulations 94 approved by this Court in *Helvering* v. *Winmill* (305 U. S. 79) does not relate to Commodity Trading but to expenditures of a capital nature, and therefore does not prohibit the deduction of commissions paid on trading in Commodity Futures.

Specification of Errors to be Urged.

The Circuit Court of Appeals erred:

(1) In holding that the taxpayer's losses from trading in Commodity Futures were losses incurred in the sale or exchange of capital assets and therefore limited to $2,000 in each of the years 1936 and 1937.

(2) In failing to hold that the taxpayer's losses from trading in Commodity Futures were ordinary losses resulting from the extinguishment of executory contracts involving neither a "sale" nor an "exchange."

(3) In holding that commissions paid by one engaged in the business of trading in Commodity Futures are not deductible as ordinary and necessary expenses.

(4) In failing to hold that Article 24-2 of Regulations 94 promulgated under the Revenue Act of 1936 does not apply to Commodity Trading but is confined to items of the nature of Capital Expenditures.

(5) In failing to hold that Article 24-2 of Regulations 94 promulgated under the Revenue Act of 1936, if

applicable to a trader in Commodity Futures, excludes only commissions on purchases as the commissions on sales are an ordinary and necessary expense.

(6) In failing to sustain the Board of Tax Appeals on the allowance of selling commissions as a deduction in computing net income.

(7) In failing to reverse the Board of Tax Appeals on its holding that losses incurred in trading in Commodity Futures are capital losses.

(8) In failing to reverse the Board of Tax Appeals on its holding that commissions attributable to the purchase of Commodity Futures are part of the cost of such Futures and not deductible.

Reasons for Granting the Writs.

(1) The question of whether or not losses incurred in trading in Commodity Futures are Capital losses or ordinary losses, and whether such trading involves a sale or exchange, are important questions of Federal law which have not been, but should be, settled by this Court.

The question is involved in all Revenue Acts since the 1936 Act, and will undoubtedly recur again in the administration of the 1936 and succeeding Acts. Unless certiorari is granted your petitioners may suffer irreparable injury, should this Court at a later date pass upon the question as a result of a conflict that may develop between different Circuits.

(2) The question of commissions and their treatment in the case of a trader is one of great importance, and arises under all of the Revenue Acts commencing with the Revenue Act of 1932 and including the Revenue Act of 1940.

Certiorari is now pending before you in the case of *Adolph B. Spreckles* v. *Commissioner of Internal Revenue*, No. 581-582, arising in the Ninth Circuit and in direct conflict with the decisions of the Circuit Court of Appeals for the Second Circuit in *Winmill* v. *Commissioner*, 93 Fed.

(2d) 494, and *Neuberger* v. *Commissioner*, 104 Fed. (2d) 649, both holding that selling commissions paid by a trader in securities are deductible.

Two cases in which the Board of Tax Appeals held selling commissions deductible are now pending in the Third Circuit. They are

Commissioner v. *Alice du Pont Ortiz*, 42 B. T. A. 173.
Commissioner v. *Bernon S. Prentice*, B. T. A. Memo decision, Dec. 6, 1940, Docket No. 100980.

Even though this Court may hold that commissions on securities are not deductible, the question as to commissions paid on commodities and commodity futures remains to be answered in the case at bar.

Conclusion.

For the foregoing reasons, it is respectfully submitted that this petition should be granted, commanding the Circuit Court of Appeals for the Fifth Circuit to certify and send to this Court full and complete transcripts of the record and all proceedings in the cases entitled Commissioner of Internal Revenue v. George W. Covington and Kate Ellis Covington, No. 9806, and George W. Covington and Kate Ellis Covington v. Commissioner of Internal Revenue, No. 9806, to the end that the said cases may be reviewed and determined by this Court as provided by law, and that petitioners may have such action and further relief in the premises as to this Court may seem proper.

DONALD A. CALLAHAN,
Attorney for Petitioners.

Of Counsel:
CARL J. BATTER,

October 8, 1941.

APPENDIX.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensations for personal services actually rendered; * * *.

* * * *

Sec. 117. Capital Gains and Losses.

* * * *

(b) Definition of Capital Assets.—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * *

(d) Limitation on Capital Losses.—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 23 (a)-1. Business expenses.—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, * * *. Among the items included in business expenses are management expenses, commissions, * * *. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses ex-

ceed the gross income derived during the taxable year from such business. * * *

* * * * *

Art. 24-2. Capital expenditures.—Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. (See section 23(1).) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architects' services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities, when such commissions are not an ordinary and necessary business expense, are an offset against the selling price. Expenses of the administration of an estate, such as court costs, attorneys' fees, and executors' commissions, are chargeable against the corpus of the estate and are not allowable deductions. Amounts to be assessed and paid under an agreement between bondholders or shareholders of a corporation, to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. (See article 22 (a)-17.) An assessment paid by a shareholder of a national bank on account of his statutory liability is ordinarily not deductible but, subject to the provisions of the Act, may in certain cases represent a loss. Expenses of the organization of a corporation, such as incorporation fees, attorneys' and accountants' charges, are capital expenditures and not deductible from gross income. A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary.

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In the Supreme Court of the United States

OCTOBER TERM, 1941

NOS. 693–694

GEORGE W. COVINGTON AND KATE ELLIS COVINGTON, PETITIONERS

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 18–26) is reported in 42 B. T. A. 601. The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 50–57) is reported in 120 F. (2d) 768.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 9, 1941 (R. 57), and a petition for rehearing was denied July 11, 1941 (R. 63).

The petition for writs of certiorari was filed October 10, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the losses resulting from dealing in commodities futures contracts were properly classified as capital losses, subject to the limitations of Section 117 (d) of the Revenue Act of 1936.

2. Whether any part of the commissions paid to brokers for placing and closing commodities futures contracts are deductible as ordinary and necessary business expenses.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1936, 49 Stat. 1648:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *
>
> * * * * *
>
> SEC. 117. CAPITAL GAINS AND LOSSES.
>
> * * * * *
>
> (b) *Definition of Capital Assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer

(whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * *

(d) *Limitation on Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23 (a)–1. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under the provisions of articles 23 (b)–1 to 23 (q)–1. Double deductions are not permitted. Amounts deducted under one provision of the Act can not again be deducted under any other provision of the Act. The cost of goods purchased for resale with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. (See article 22 (a)–5.) Among the items included in business expenses are management expenses,

commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, * * *

* * * * *

ART. 24–2. *Capital expenditures.*— * * * Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities, when such commissions are not an ordinary and necessary business expense, are an offset against the selling price. * * *

STATEMENT

This case involves the income tax liability of George W. Covington[1] for the years 1936 and 1937. The facts, as found by the Board of Tax Appeals (R. 19–21), may be stated as follows:

The taxpayer has been engaged for some 20 years in trading individually in commodities futures pertaining to cotton and related products. He devoted a substantial part of his time to such trading, and was a member of the New York Produce Exchange, the Memphis Cottonseed Exchange, Merchants Exchange, and the National Cottonseed Products Association. He kept abreast of the current movements of the commodities through the trade journals to which he subscribed and through statistical information compiled with the assistance of a research man employed for that purpose (R. 20).

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[1] His wife was named in the litigation because a joint return was filed (R. 7).

In the taxable years, brokers' commissions paid by the taxpayer and his losses on trading in futures contracts were as follows (R. 20):

	1936	1937
Commissions	$2,880.00	$39,619.00
Trading losses	25,120.00	58,716.00

All of the transactions involving futures contracts were executed on exchanges whose rules are substantially in accord.[2] The taxpayer did not take delivery of any commodities on futures contracts during the taxable years 1936 and 1937 (R. 21).

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[2] The rules of the New York Produce Exchange provide that all offers to buy and sell shall be presumed to have been made in the following form (R. 20–21):

"_____ of the County of _____ State of _____ have this day-{bought from / Sold to} _____ and agreed to{receive from / deliver to}_____ of the County of _____ State of _____ 60,000 pounds of loose Bleachable Prime Summer Cotton Seed Oil, at a price of _____ cents and _____ hundredths cents per pound, in licensed bonded warehouse basis f. o. b. New York; deliverable between the first and last days of _____ inclusive; at seller's option. The oil dealt with herein shall be Prime Summer Yellow Cotton Seed Oil; shall be of American origin, and produced within the United States of America, and must be clear, free from water and settlings, sweet in flavor and odor, and when bleached as per Rule 101 of the Rules Governing the Chemistry Bureau, the color of the oil to be passed upon shall not be darker than the combined standard glasses .20 yellow, 2.5 red of Lovibond's color scale, and shall not contain more than one-quarter of one percent free fatty acids.

"This agreement is made subject to all the By-laws, Rules and customs of the New York Produce Exchange."

Commissions to brokers in handling the purchases and sales on the various exchanges were paid when each purchase and sale, each trade or contract, was consummated. The commissions were neither buying nor selling commissions as such, but were charges by brokers for placing and closing the futures contracts on the various exchanges (R. 21).

The Board concluded that (R. 24–25) the losses were capital losses subject to the statutory limitation, but that (R. 26) one-half of the commissions was deductible as business expenses attributable to the sales.

The Government appealed (R. 27–32) with reference to the deductibility of sales commissions as expenses, and the taxpayer appealed (R. 37–42) with reference to the disallowance of purchase commissions and with reference to the ruling that the losses were capital losses. The court below sustained the Government on all issues.

ARGUMENT

1. The first ground of the petition presents no basis for the issuance of the writ. No contention is made that there is any conflict on this issue (Pet. 6). The court below correctly decided that (R. 53) the petitioner was engaged in buying and selling commodities or rights in commodities and that the losses incurred therein were capital losses subject to the limitation of Section 117 (d), *supra*.

2. There is, however, a conflict of decisions as to whether broker's commissions upon sales of securities are deductible as expenses (rather than being employed to reduce the amount of the sales price), that question is raised in *Spreckels* v. *Helvering,* Nos. 581–582, this Term, certiorari granted October 20, 1941. The commissions involved herein are not strictly sales commissions; the taxpayer paid a single commission upon the initiation and the closing of a futures transaction, and the Board of Tax Appeals treated one-half thereof as comparable to a sales commission. The court below likewise treated one half of the commissions as sales commissions and was of the opinion that its decision was contrary to those of the Second Circuit in *Winmill* v. *Commissioner,* 93 F. (2d) 494, and *Neuberger* v. *Commissioner,* 104 F. (2d) 649. In these circumstances, it would be appropriate for the Court either to grant the petition on this point, or to withhold action thereon until the disposition of the *Spreckels* case.

CONCLUSION

The decision of the court below is correct. There is no conflict except with respect to the commissions issue. If granted, the writ should be limited to that issue.

Respectfully submitted,

WARNER W. GARDNER,
Acting Solicitor General.

OCTOBER 1941.

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